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American Institute of Certified Public Accountants. SEC Practice Section. Public Oversight Board

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STATEMENT OF AULANA L. PETERS
MEMBER, PUBLIC OVERSIGHT BOARD
BEFORE THE SENATE BANKING COMMITTEE
MARCH 19, 2002

Good morning Mr. Chairman. Thank you for giving me this opportunity to share my views on the issue of reform of the accounting profession's self-regulatory structure. In a conversation I had with the Robert Herdman, Chief Accountant of the SEC last January, he commented that there are times when reform can and should be evolutionary and times when it must be radical. Based on my oversight experiences as a member of the POB, I had begun to conclude that the profession's self-regulatory structure needed reform and was looking forward to working with the profession and within the structure of the POB to develop those reforms. But the crisis precipitated by the Enron scandal and other events have created an environment of urgency. So, here we are. The Chief Accountant did not tell me whether he thought the times called for evolutionary change or radical change. In my view, the current state of affairs requires the change to be radical and immediate.

Before proceeding with my testimony, I wish to emphasize that the views I am about to express are based on my observations and conclusions about flaws in the current self-regulatory process. I believe these flaws are inherent in the structure itself and are not the result of any lack of competence of the professionals who serve as members of the Auditing Standards Board (ASB), the Quality Control Inquiry Committee (QCIC) or the Peer Review Committee of the SEC Practice Section of the American Institute of Certified Public Accountants (SECPS). During the past year, I have observed dozens of accounting and auditing professionals devote countless hours and enormous energy to setting standards, investigating alleged audit failures

and conducting peer reviews. The individuals involved in these processes are, without a doubt, highly intelligent, undeniably expert and extraordinarily dedicated. These men and women are not compensated for contributing their talents and skills to the work of the various committees of the American Institute of Public Certified Accounts (AICPA). Their reward is the satisfaction of knowing that their efforts are directed at improving the financial reporting process.

General Structure

Chairman Bowsher has summarized for you the most important points of the self-regulatory structure the POB believes is the most appropriate model for the accounting profession. It achieves the streamlining of what commentators like to call the "alphabet soup" of governance, by bringing all standard setting under one roof, eliminating overlapping and untimely disciplinary procedures, and by strengthening and adding transparency to what was the peer review process.

Based on my observations and experiences, I have concluded that it is critical for the power of any new self-regulatory structure to be based in legislation. This is essential for the independence, certainty and long-term viability of whatever entity is created. For example, without a legislatively-based source of authority and funding, the new regulatory entity would be vulnerable to pressure from the persons it regulates or who are directly affected by its regulation.

Furthermore, I believe that streamlining the current governance system is not likely to be accomplished through negotiation and compromise. For example, the SEC proposal is just such a negotiated compromise and I am advised that it leaves standard setting and the discipline of "smaller" firms with the AICPA. Furthermore, it does not deal with the Financial Accounting

Standards Board. Consolidating all self-regulatory activities under one umbrella regardless of vested interests is important for efficiency, effectiveness and cost savings.

Most importantly, any new self-regulatory structure must be completely independent of the profession. In my opinion it is not enough to create an entity in which the public members "predominate," whether by a simple or super majority. No member of the new "board" or "institute" or "panel" should be affiliated with or responsible to any accounting firm or the AICPA. That does not mean that the self-regulatory process should not tap the talent and expertise of the profession. There are other ways to achieve that end. For example, retired leaders from the accounting profession such as Michael Cook, Shaun O'Malley or Robert Mednick, just to mention a few, could be called upon to serve. In addition, former chief executive officers, chief financial officers and well-known and respected institutional money managers would contribute vital input to the process from the perspective of preparers and users of financial statements.

The Structural Changes

From the public's perspective, I think that one of the most important aspects of the new self-regulatory process will be that which is focused on discipline. To the extent that the discipline can be structured to have a diagnostic element, as well as a punitive/remedial one, both the accounting profession and the public will benefit.

1. Quality Control

The objective of the peer review process is to evaluate the design of and test compliance with a firm's quality control system with a view to determining whether there are weaknesses, deficiencies or other problems within the system that would likely contribute to or result in sub-

standard audits. However, I believe that peer review is not, as currently structured, a good diagnostic tool for reviewing the quality control system with a view to detecting and remedying flaws that result in a particular substandard audit. Furthermore, the peer review process is not predictive in that it has not been an effective tool for identifying how and why auditors in the field make bad judgment calls.

I think that the POB's recommendation that the triennial peer review be replaced by a re-tooled annual review conducted by the new regulatory agency will make the review process a more useful diagnostic tool even though it is unlikely that it can be more predictive. In my view, regardless of whether a review is triennial or annual, it will not prevent future audit failures although it can be enhanced to better serve its purpose of quality control. The POB proposal calls for the process to become:

- Independent of and from the firm being reviewed by transferring the activity to the self-regulator. This change may enhance scrutiny of quality control by avoiding potential biases in a system where competitors, having possible incentives to not burden the system with additional obligations or otherwise act to their own detriment, perform the review.

- Applicable to all engagements selected through the sampling process with no engagement being excluded from the review simply because it is, or possibly could be, the subject of litigation. Such engagements provide an opportunity to examine challenged audits to test compliance with quality controls and receive timely information on what went wrong with the quality control system and therefore could help avoid future audit failures.

- More transparent in that the reports issued include a description of (1) the limitations of the review and (2) the findings (whether "best practices" or "deficiencies") by the reviewing team.

2. Discipline

The current QCIC process is designed to review cases that are the subject of litigation to determine if there is a systemic problem at a firm whose audits become the subject of litigation. If during the course of this review the committee finds a problem with an individual's performance on the specific audit, it may refer the matter to the Professional Ethics Executive Committee (PEEC) and recommend action to be taken by the firm with respect to the specific individual. In my view, the QCIC and PEEC processes are flawed because they are segregated from one another and thus are not geared to react quickly to bad judgment calls that do not signal a breach of the quality control system; they are structured to have no impact on pending litigation which weakens the diagnostic or remedial benefits of their actions; and their ability to gather facts is limited.

The POB recommendations address these issues by combining the QCIC and PEEC processes into a single disciplinary system for all auditors, so that issues of quality control are not divorced from those of individual performance. The new regulatory entity will be responsible for both identifying problems and remedying them. It will also conduct the annual reviews; consequently the information gleaned and lessons learned should naturally feed back into the standard setting process on a timely basis.

The POB, as does the SEC, recommends that the new regulatory body have the power to compel the production of documents and take testimony, thus giving it authority to investigate fully allegations of audit failure or accountant malfeasance. Greater access to information should facilitate a deeper probing of the possible causes of alleged audit failures. However, the POB's proposal differs from that of the SEC in that it provides for no deferral process. This difference

is important because the POB model goes farther in assuring the public that the disciplinary process is working and that errant accountants are being held accountable.

POB Termination

Finally, I would like to comment on the question of why the POB voted to disband and reiterate the particular facts that motivated me to vote with my colleagues. For me the key facts are:

On December 4, 2001, the POB learned, after the fact, that the Chairman of the SEC had met with representatives of the AICPA and the "Big Five" to discuss the implications of the Enron disclosures for the profession and its self- regulatory structure.

On January 4, 2002, the POB attended a meeting of the Executive Committee of the SEC Practice Section at which it learned from a committee member that the AICPA had formed a working group to formulate a proposal for a new self-regulatory structure to submit to the SEC. Comments were made to suggest that an announcement of the plan was anticipated within a few weeks. This was the first time that the POB was advised of the existence of this task force and its work. The POB immediately asked to be included in and advised of the progress of the working group's activities as part of its oversight duties.

On January 17, 2002, the POB was informed for the first time that that morning the Chairman of the SEC would hold a press conference to announce his plans for changes to the accounting profession's self-regulatory system. Subsequently, but prior to finalizing its decision to disband, the POB learned that AICPA working group had submitted its proposal to the SEC a week prior to the January 17th press conference.

Thus, the POB the independent body charged with oversight of the accounting profession and in that regard assigned the duty to act in the public interest was effectively excluded from a process of great moment for the profession and the public it serves. I for one am not concerned about whether the exclusion was intentional or the unintended result of bad timing. Regardless of "why", circumstances were created in which the POB could not effectively perform its oversight duties. The POB cannot be the public's eyes and ears in an informational vacuum. Furthermore, the POB is a creature that exists at the sufferance of the SEC and the accounting profession. Consequently, whatever authority attaches to its activities and recommendations is based on a consensus of the SEC and profession that the views of the POB are relevant and of significance. Thus, being excluded from a process which Chairman Pitt reportedly described a producing "unprecedented " change for the accounting profession clearly signaled the POB's perceived irrelevancy and emphatically undercut its authority and legitimacy.

Thank you for your time and patience. I would be pleased to answer any questions you may have.